Testimony Of Michael R. Haverty

Senate Committee on Commerce, Science and Transportation
Subcommittee on Surface Transportation and Merchant Marine

June 28, 2001

Good afternoon Mr. Chairman, members of the Committee. My name is Michael R. Haverty. I am Chairman, President, and Chief Executive Officer of The Kansas City Southern Railway Company. I am pleased to appear before you today, and I thank you for the opportunity to discuss KCS's thoughts on the recently released final rules for major rail mergers and their impact on the country's railroad system.

I would like to begin my comments by explaining the role that KCS plays in the national railroad system. KCS is the smallest of the Class I railroads. See Exhibit A. Using 1999 annual operating revenues available from AAR, KCS's revenues were approximately $564 million dollars. In comparison, the next largest Class I carrier, Canadian Pacific Railway ("CP") (including its U.S. subsidiary, Soo Line Railroad), had annual operating revenues of approximately $2.4 billion dollars. The largest Class I carrier, Union Pacific Railroad ("UP"), is over 17 times the size of KCS with annual operating revenues of approximately $10 billion dollars. In comparison, KCS is much closer in size to Wisconsin Central's U.S. rail operations, that include a Class II railroad, and had combined annual operating revenues around $400 million dollars. A quick look at the miles of road operated by each Class I carrier reveals the same story of disparate size differences. KCS's miles of road operated (including Gateway Western Railway) in 1999 was 3,158; CP's miles (including the Soo Line) were

14,358; UP's miles were 33,341 and WC's miles were 2,756. See Exhibit B. Notably, WC would have become a Class I railroad under existing criteria on January 1, 2002 if the recently announced acquisition by the Canadian National Railway had not occurred. Also, notably, the Surface Transportation Board (STB or the Board) determined this transaction would be treated as minor, the most lenient treatment available for proposed rail mergers.

KCS was founded in the 1880's by a visionary that sought to connect America's heartland to the Gulf of Mexico to move Midwest agricultural products by rail to southern states and by ship to other countries. KCS's main lines ran from Kansas City to Lake Charles, Louisiana and Port Arthur, Texas. In the 1930's, a line between Dallas and New Orleans via Shreveport, Louisiana was added to the KCS network. In 1993, KCS purchased a strategic line from Shreveport to Meridian, Mississippi via Vicksburg and Jackson. KCS's rail network remained in this configuration as a regional railroad until 1995.

In 1995, the Union Pacific/Chicago & North Western and the Burlington Northern/Santa Fe mergers were approved by the Interstate Commerce Commission (ICC), completing another wave of major rail mergers. See Exhibit C. That same year, the proposed Union Pacific/Southern Pacific merger was announced, and it was subsequently approved by the STB, the successor to the ICC. As a result, KCS found itself facing the possibility of extinction as two major rail carriers were created that would control 90% of the traffic west of the Mississippi River.

In an entrepreneurial reaction, KCS, in a span of about three and one-half years, became part of a "NAFTA Railway" network, spanning from Canada to Mexico. This network was created through a series of acquisitions, investments and strategic marketing alliances. The interesting thing to note is that KCS added only about 450 miles of rail ownership to the company that it controls. The rest of the network was created through minority investments and strategic alliances. KCS is one-tenth of the size of the two major railroads it competes against in the west, Burlington Northern Santa Fe (BNSF) and Union Pacific because Kansas City Southern does not actually own controlling interest in trackage beyond its 3,158 miles compared, for example, to Union Pacific's actual ownership of over 33,000 miles of trackage and BNSF ownership of over 33,000 miles of trackage as well.

Subsequent to the two major rail mergers approved in the west, two major rail carriers were also created in the east when the CSX and Norfolk Southern purchase of Conrail was approved by the STB. As a result of these major rail transactions, two giant rail carriers dominated traffic in the west and two dominated traffic in the east. Besides these four major rail carriers in the United States, there are two major railroads in Canada and two in Mexico. (KCS owns a minority position in one of the two Mexican systems.) Because previous STB decisions have established that two carriers are adequate competition in the United States and there are only two major rail carriers today in Canada and Mexico, the likelihood of eventually seeing only two major rail companies in all of North America is strong. However, the premise that KCS would be the catalyst of triggering a move to the final end game of mergers, with ownership control of only 3,158 miles of track in a 100,000 plus mile major rail network in North America, is, in my opinion, unrealistic.

The mergers and other changes that have taken place in the rail industry over the past two decades have in part been the result of the major merger regulations enforced by the ICC, and (since 1996) by the STB. Shortly after the enactment of the Staggers Rail Act of 1980, the ICC modified its merger regulations to place a premium on the reduction of excess capacity which was deemed to be choking the large railroads. Under these merger regulations, consolidation was encouraged as long as it was not deemed to unacceptably reduce competition. Along with the liberalization of abandonment rules and, perhaps most significantly, the reduction in government regulation of ratemaking and other service issues, the merger regulations implementing the Staggers Act helped to return the railroad industry from the brink of financial ruin.

The railroad industry that we see today is largely the result of the ICC's and STB's interpretation of the post-Staggers merger standards. However, it has now been determined that the reduction of excess capacity should not be the primary goal of future rail mergers. KCS supports that concept and supported the STB's 15-month merger moratorium imposed in March 2000, and we were pleased when the moratorium withstood a challenge in court.

The purpose for imposing the moratorium, according to the Board, was to allow the Board time to re-write the merger regulations, to better address the competitive and service issues which would now arise from a round of final combinations. KCS also supported the Board in its pursuit of these goals. However, I would like to make it clear that KCS has not been, and is not, part of the "mega-carrier" problem that the STB sought to address in its new regulations.

KCS actively participated in the STB's review of its merger rules - a process which spanned 15 months. At each step in the proceeding, KCS filed comments proposing modest changes which we believed could put the merger regulations more in tune with the modern rail industry. See Exhibit D. KCS's written comments were contained in hundreds of pages of text, all of which reflected views on improving the rail system as a whole. We were also represented by our regulatory counsel at an oral hearing conducted by the STB to facilitate a dialogue on the Board's revision of the merger rules.

At each step in the Board's review proceeding, KCS urged the Board to consider seven specific proposals for improving its regulation of major rail mergers. Those seven points were as follows:

1. **Rail Service Options Should Be Preserved In Merger Proceedings**

2. **Service Restrictions Contained In Marketing, Haulage And Trackage Rights Agreements Imposed As Merger Conditions Should Be Disclosed And Justified**

3. **Benefits Claimed From Prior Mergers Should Be Preserved**

4. **Applicants Should Be Required To Disclose And Discuss The Impact Of Related Negotiated Agreements In Merger Proceedings**

5. **Recent Cancellations Of Reciprocal Switching Access Should be Disclosed and Discussed.**

6. **The Definition of "Major" Merger Transactions Should Be Limited To Mergers Involving Only The Largest Railroads.**

7. **Merger Applicants Should Be Required To Disclose And Discuss Paper And Steel Barriers Applicable To Their Shortline Interchange Connections**

KCS was pleased that our seven modest proposals generated a significant amount of discussion in the merger rule proceeding. Although none were adopted in totality, other railroads, government agencies, and shippers all made comments directly or indirectly supporting or opposing the suggestions made by KCS. KCS has supported the STB's new rules.

Since I assumed the Presidency of KCS in 1995, we have been actively involved in all of the major rail mergers, urging the STB and the ICC before it to maintain as a guiding principle the preservation of rail competition. Railroading involves enormous capital expenses. Unlike the trucking industry, for example, where underserved markets can be remedied with the purchase of some trucks, railroads must pay for their own infrastructure, meaning that it is virtually impossible for any new rail systems to be built. In short, the rail systems we see today are likely all we will have to work with for many years to come. For that reason, we have repeatedly asked the Board to make sure that rail mergers do not reduce competitive options to shippers in major transactions.

Over the last few weeks, some have questioned the majority of the Board's approval of a regulation grandfathering any potential merger of KCS and another Class I carrier under the Board's former regulations governing major rail mergers. The final regulation is different than the proposal put forth by KCS, which was that such a merger be reviewed as a "significant" transaction, not a major one, under the new merger regulations. The Board's rule is different from what we proposed but is based on the same facts that spurred our original proposal 15 months ago: KCS's limited market reach simply cannot support the types of concern over service and competitive issues which will dominate future mergers of the other Class I carriers. The "grandfathering" of KCS, under the previous rule, which is fair and appropriate, is a rebuttable presumption that could be challenged by a concerned party if they desired to do so.

I would like to conclude my comments with a few observations on KCS's independence. Many parties have been speculating that the recent adoption of the STB's major merger regulations is nothing short of a "For Sale" sign on KCS. The people making that speculation have simply not watched us over the past few years. KCS has worked diligently to maintain its independence while entering alliance and marketing agreements to extend its reach and better serve our customers. We have worked hard to develop on-line business opportunities, and to work with our connecting carriers to better serve our shippers. We are currently involved in the construction of a new headquarters building in downtown Kansas City, an action that we would not be taking if we were looking to exit the market as an independent carrier. It is true that we are a publicly-traded company, and thus in some sense our future rests in the hands of those who invest in our stock. Additionally, we must protect the interest of not only our shareholders but our customers and employees as well. But a railroad so dwarfed by major carriers around it with limited geographic reach may well prove to be in no one's best interest. But, in the meantime, we will continue to focus our energies on keeping KCS a strong, reliable carrier, one with a proud heritage and a challenging future.

Again, I want to thank the Subcommittee for giving me the opportunity to testify today. I would be pleased to answer any questions you might have.